No. 83-299

In the Supreme Court of the United States

OCTOBER TERM, 1983

HENRY C. TILFORD, JR. AND
BARBARA N. TILFORD, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Section 1.83-6(d) of the Treasury Regulations provides that, if a shareholder of a corporation transfers stock to an employee of the corporation in consideration of the employee's performance of services for the corporation, the shareholder shall be considered to have made a contribution to the corporation's capital rather than a sale of the stock. The question presented is whether the court of appeals correctly upheld the validity of this Regulation.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-10a) is reported at 705 F.2d 828. The opinion of the Tax Court (Pet. App. 14a-43a) is reported at 75 T.C. 134.

JURISDICTION

The judgment of the court of appeals was entered on April 20, 1983. A petition for rehearing was denied on May 27, 1983 (Pet. App. 11a). The petition for a writ of certiorari was filed on August 23, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Henry C. Tilford, Jr., was the principal officer of Watco, Inc. and, at the end of 1970, owned 100% of its issued shares (Pet. App. 2a). Watco lost money consistently. In order to induce well-qualified individuals to

work for Watco, petitioner entered into restricted stock agreements with current and prospective employees (Pet. App. 16a-21a). Under these agreements, which were substantially identical, petitioner transferred some of his Watco shares, in blocks of varying size, to key employees of the company. The size of each block depended on the employee's perceived importance to Watco; each block was "sold" at the nominal price of $1, regardless of the number of shares transferred (Pet. App. 2a, 16a-21a). Each transfer was subject to a restriction giving petitioner the right of first refusal to repurchase the shares at book value if the employee left Watco (Pet. App. 2a, 16a). Watco continued to experience difficulties and the key employees gradually left the company; petitioner repurchased the stock from each departing employee, generally for $1 per block (Pet. App. 19a-21a).

On his individual tax returns for 1971-1973, petitioner claimed losses from his sales of Watco stock to Watco employees, taking deductions of $370,992, $150,497 and $159,246, respectively (Pet. App. 2a). Since petitioner sold each block of stock for $1, these deductions approximated his basis in the shares transferred. The Commissioner disallowed these loss deductions, contending that petitioner's transfers of the restricted stock were transfers of property "in connection with the performance of services" and hence were governed by Section 83 of the Code[1] and its implementing regulations. Those regulations provide that "[i]f a shareholder of a corporation transfers property to an employee of such corporation * * * in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to

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[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended ("the Code" or "I.R.C.").

the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee * * *." Treas. Reg. § 1.83-6(d)(1).

2. Petitioner sought redetermination of the Commissioner's proposed deficiencies in the Tax Court. That court, in a reviewed decision with six judges dissenting, invalidated Treas. Reg. § 1.83-6(d), holding that it was "outside the scope of the statutory provisions of [S]ection 83" (Pet. App. 28a). The court of appeals reversed, one judge dissenting. The majority held that the Regulation was "consistent with both the legislative history and statutory intent" of Section 83, as well as with this Court's decisions in *Deputy* v. *DuPont*, 308 U.S. 488 (1940), and *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590 (1943). In the majority's view, those decisions stood for the proposition that "payments made by a stockholder for the benefit of his corporation are not deductible by the stockholder" (Pet. App. 4a-5a). The dissenting judge believed that the legislative history provided an inadequate basis for the Regulation, absent explicit language in Section 83 itself dealing with the treatment of shareholders in petitioner's position (Pet. App. 7a-10a).

ARGUMENT

The court of appeals correctly sustained the validity of Treas. Reg. § 1.83-6(d), which on its face denies petitioner the loss deductions he claimed. The Regulation represents a reasonable construction of Section 83 and is thoroughly consistent with — indeed, is grounded almost *verbatim* upon — the legislative history of that section. Petitioner does not allege (nor is there) a conflict among the circuits on this question. There is no basis for review by this Court.

1. This Court has consistently held that Treasury Regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes" and "should not be

overruled except for weighty reasons." *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). Accord, *e.g.*, *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 533 n.11 (1979); *Bingler* v. *Johnson*, 394 U.S. 741, 750 (1969). Treasury Regulations, moreover, have "particular force" where they represent "a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent." *National Muffler Dealers Ass'n, Inc.* v. *United States*, 440 U.S. 472, 477 (1979). Accord, *e.g.*, *Commissioner* v. *Tufts*, No. 81-1536 (May 2, 1983), slip op. 16 n.17.

2. Congress enacted Section 83 in 1969 in order to provide comprehensively for the tax treatment of property —particularly, restricted stock — that is transferred "in connection with the performance of services." Tax Reform Act of 1969, Pub. L. No. 91-172, § 321(a), 83 Stat. 588. Section 83(a) provides generally that the value of property transferred in connection with services "shall be included in the gross income of the person who performed such services" when the latter's rights become substantially vested, *i.e.*, when the restrictions on his or her ownership lapse. Section 83(h) sets forth a parallel rule governing deductions by the employer. It provides that "there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal" to the amount included in the employee's income. Section 83(h) also provides that the employer's deduction shall be allowed in "the taxable year * * * in which such amount is included in the gross income of the person who performed such services." Accordingly, as Judge Simpson noted in his Tax Court dissent (Pet. App. 41a), Section 83(h) accomplished two objectives. It clarified previous law by making a deduction available to *the employer*, regardless of who formally

transfers the stock. And it mandated that the employer take deductions *in the same taxable year* that the employee recognizes income.

Treasury Regulations interpreting Section 83 were published in proposed form in June 1971 (36 Fed. Reg. 10787) and in final form in July 1978 (T.D. 7554, 1978-2 C.B. 71); the regulations thus represent a "contemporaneous construction" of the statute.[2] Section 1.83-6 establishes general rules governing the allowance of a deduction to the employer. Section 1.83-6(d) sets forth a "[s]pecial rule[] for transfers by shareholders," providing that such a transfer, if made to an employee of the corporation in consideration of services performed for the corporation, shall be treated as a capital contribution by the shareholder to the corporation, followed by a transfer of the property by the corporation to the employee.

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[2]There is no merit to petitioner's contention (Pet. 6-7 n.2) that the regulations cannot properly be applied retroactively to his 1971-1973 tax years. Section 7805(b) provides that Treasury Regulations generally apply retroactively, leaving it up to the Commissioner's discretion to "prescribe the extent, if any, to which any * * * regulation * * * shall be applied without retroactive effect." The regulations were pending in proposed form when petitioner filed his tax returns for 1971-1973, and the proposed and final versions of Section 1.83-6(d) were substantially identical in treating transfers like petitioner's as capital contributions. Compare 36 Fed. Reg. 10793 (1971) with T.D. 7554, 1978-2 C.B. at 83. Thus, there is no basis for contending that the Commissioner here abused his discretion by "promulgat[ing] retroactive regulations during the course of a litigation for the purpose of providing himself with a defense based on the presumption of validity" accorded them. Pet. 7 n.2, quoting *Chock Full O'Nuts Corp.* v. *United States*, 453 F.2d 300, 303 (2d Cir. 1971). The delay in promulgating the regulations in final form was due to the Treasury's decision to redraft certain sections in response to taxpayers' comments at the public hearing. T.D. 7554, 1978-2 C.B. at 72. Since the regulations were proposed promptly, this delay obviously does not make their construction of the statute any less "contemporaneous."

As the court of appeals properly held (Pet. App. 5a-7a), Treas. Reg. § 1.83-6(d) provides a reasonable interpretation of Section 83's operation in situations where restricted stock is transferred, not by the employing corporation, but by one of its shareholders. As noted above, Section 83(h) states that the employer is entitled to "a deduction under section 162" in such circumstances. Section 162, however, allows a business-expense deduction only for amounts "paid or incurred during the taxable year." If the compensatory transfer is nominally made by the shareholder, it is not obvious how the employer is entitled to a business-expense deduction, since the employer has not literally "paid or incurred" anything. Section 1.83-6(d) offers a logical explanation of how the employer's deduction arises in this situation, viz., by treating the shareholder's purported "sale" as a contribution to the corporation's capital, followed by a compensatory transfer by the corporation to the employee.

If there were any doubt that the challenged Regulation faithfully reflects Congress's understanding of how Section 83 was meant to operate, that doubt would be removed by the legislative history. The report of the Senate Finance Committee, which added Section 83(h) to the bill, explained (S. Rep. 91-552, 91st Cong., 1st Sess. 123-124 (1969)):

> "In general, where a parent company's or a shareholder's stock is used to compensate employees under a restricted stock plan, the transfer of the stock by the parent company or shareholder is to be treated as a capital contribution to the company which is to be entitled to a deduction in accordance with the restricted property rules."

As petitioner concedes (Pet. 9), it cannot be doubted that Section 1.83-6(d) "is faithful to this language."

3. The challenged Regulation is likewise consistent with general tax principles. It is well established that the tax consequences of a transaction are determined by its substance, not by its form. *E.g.*, *Gregory* v. *Helvering*, 293 U.S. 465 (1935). And it is well established that a shareholder is not entitled to business-expense deductions for payments made for the benefit of his corporation, since such payments are incurred, not in his, but rather in his corporation's, trade or business. See *Deputy* v. *DuPont*, 308 U.S. 488, 493-494 (1940) (denying deduction to shareholder for expenses incurred in transferring incentive stock to corporate employees). Accord, *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593-594 (1943). Cf., *e.g.*, *United States* v. *Generes*, 405 U.S. 93, 101 (1972) (bad debts); *Whipple* v. *Commissioner*, 373 U.S. 193, 202-203 (1963) (same). In the present case, petitioner's purported "sales" of stock to Watco's employees represented, in substance, compensation to them from Watco, the corporation for which they worked. Section 1.83-6(d) follows accepted tax principles by denying petitioner a loss deduction in these circumstances, and by recasting his "sales" as capital contributions so that the form of the transactions accords with their substance.[3]

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[3]Petitioner (Pet. 7-8) and the Tax Court majority (Pet. App. 28a) err in urging that the challenged Regulation conflicts with Section 1001(c) and its predecessors. That Section provides generally that, "[e]xcept as otherwise provided in [the Code], the entire amount of the gain or loss * * * on the sale or exchange of property shall be recognized." As Judge Simpson noted in his Tax Court dissent (Pet. App. 41a), however, Congress's decision in Section 83(h) to allow the employer a deduction for property transferred by a shareholder in connection with services makes clear that "Congress rejected the view that the transaction was merely a sale by [the] shareholder to [the] employee." Since petitioner's transfer was not, in substance, a "sale," Section 1001(c) has no application; its general rule must yield to the more specific provisions of Section 83.

4. The decision below is likewise consistent with the only other court of appeals decision that has considered an issue similar to that presented here. In *Schleppy* v. *Commissioner*, 601 F.2d 196, 198 (1979), rev'g 66 T.C. 622 (1976), the Fifth Circuit held that a shareholder's transfer of stock to his corporation to help improve its financial condition was a contribution to capital, not a "sale or exchange" capable of generating a tax-deductible loss. As noted below (Pet. App. 2a-3a, 6a-7a), Section 1.83-6(d) is strongly supported by the rationale of that decision, *i.e.*, that a shareholder is not entitled to a tax deduction when he transfers stock for the benefit of his corporation.[4]

5. Contrary to petitioner's contentions, therefore, Section 1.83-6(d) neither "is at odds with the plain language of the statute" (Pet. 10) nor "goes far beyond the plain language of section 83(h)" (Pet. 7). Rather, the Regulation simply makes explicit a mode of analysis that is necessarily implied by the operation of the statute Congress enacted. Petitioner seems to concede that statutes do not always "offer plenary solutions to the problems they address" and that regulations may permissibly "fill in the spaces that statutes do not reach" (Pet. 10). The Regulation at issue does just that.

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[4]The other cases cited by petitioner (Pet. 8) are for the most part Tax Court opinions that antedated this Court's decision in *Deputy* v. *DuPont*, *supra*, the Fifth Circuit's decision in *Schleppy*, and Congress's enactment of Section 83. To the extent those opinions conflict with the decision below, they are erroneous for the same reasons that the Tax Court majority was wrong here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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OCTOBER 1983

DOJ-1983-10